

ANALYSIS OF AON HEWITT'S MODELLING

UCU's actuarial advisors, First Actuarial, calculate that the proposed system will yield annual pensions that are 39%-53% lower than pensions under the current system, dependent on the member's age and career path.¹

UUK claims, on the other hand, on the basis of modelling by actuarial advisors Aon Hewitt,² that, under the proposed scheme, "current members should continue to receive retirement incomes which are equivalent to 80-90% of those received currently in terms of monetary value".³

Aon Hewitt considers seven hypothetical members, with a variety of salaries and ages.

For salaries in the range £20,000-£50,000, the results are similar: the annual pension earned from future service will be 25%-31% lower under the proposed system than under the current system. Higher-paid members are treated more favourably: for a salary of £60,000 the pension is reduced by 27%; for a salary of £90,000 the pension is reduced by only 18%.

To these figures Aon Hewitt then adds the state pension, the pension earned from past USS service, and the value of the USS life cover and incapacity benefit. None of these is affected by the proposed changes. The only possible reason to include these irrelevant items is to make the percentage changes smaller. This brings the reductions into the range claimed by UUK.

This, however, is not a like-for-like comparison between the current system and the proposed system.

Firstly, Aon Hewitt's assumptions on investment returns are about 0.6%-0.7% higher than the assumptions used by USS in its valuation (comparing 'best estimate' values). This matters a great deal, because the results are highly sensitive to the assumed return rate, which is used to set the discount rate used to value the liabilities. Increasing the

¹ Report for UCU: A comparison of TPS with USS with and without a salary threshold', First Actuarial, 29/11/17.

https://www.ucu.org.uk/media/8916/TPS--USS-no-DB-comparison-First-Actuarial-29-Nov-17/pdf/firstactuarial_ussvtps_nodb_29nov17.pdf

² 'Modelling of UUK's proposed USS benefit changes', Aon Hewitt, 12/12/17.

<http://www.employerspensionsforum.co.uk/sites/default/files/uploads/aon-hewitt-modelling-proposed-uss-benefit-changes.pdf>

³ 'USS Benefit Reform: Modelling member outcomes', 13/12/17.

<http://www.employerspensionsforum.co.uk/epf-news/uss-benefit-reform-modelling-member-outcomes>

assumed return rate by 0.1% reduces USS's deficit by £1.2bn.⁴ If USS adopted Aon Hewitt's assumptions, the deficit would disappear. If Aon Hewitt adopted USS's assumptions, the returns from the defined-contribution scheme would be lower: for salaries in the range £20,000-£50,000, the pension is reduced by 33%-39%; for a salary of £60,000 the pension is reduced by 30%; for a salary of £90,000 the pension is reduced by 21%.⁵

Secondly, we have assumed so far that, under the proposed system, members take their pension on a drawdown basis. This means that, when you retire, you must decide how long you are going to live, and then cash in the appropriate fraction of your individual pension fund every year. This method has some drawbacks. If you die sooner than you expected, part of your fund is wasted. If you live longer than you expected, your fund runs out while you are still alive. If the fund value fluctuates near the end of your life, your pension fluctuates with it.

If instead we assume that the pension is taken as a lifetime annuity (as under the current system), then the expected annual pension is further reduced. For salaries in the range £20,000-£50,000, the pension is reduced by 46%-50%; for a salary of £60,000 the pension is reduced by 43%, for a salary of £90,000 the pension is reduced by 33%.⁶

Finally, the current system provides a pension to the member's spouse if the member dies first. The proposed system (as modelled by Aon Hewitt) does not. If a spouse's pension is to be included, the reductions in pension will be even greater.

⁴ USS Consultation Document, 1/9/17, Appendix D.

https://www.sheffield.ac.uk/polopoly_fs/1.728969!/file/USSTechnicalprovisionsconsultationdocumentSept2017.pdf

⁵ These figures are taken from the line 'DC Pension assuming CPI proxy increasing drawdown' n.2, p.13.

⁶ These figures are taken from the line 'DC Pension assuming CPI proxy increasing annuity' n.2, p.13.

THE CASE FOR DEFENDING THE USS AS IT STANDS

This is the most fundamental change in the history of USS and will have a profoundly detrimental effect on members' income and security in retirement. Moreover, we believe it is unnecessary, as USS has substantial assets and the contributions it receives are sufficient to cover its pension payments. We will outline below why the main justification for this change is flawed.

1. Investment risk is transferred from the pension scheme to the members

Under our present DB scheme we are promised a certain income (1/75th of salary) for each year of service, and we can use this information in planning our career choices. Under a DC scheme the size of our pension depends on investment performance and is unknown until the day we retire.

2. DC schemes are poor value for money

Calculations by UCU's pensions expert Michael Otsuka show that the proposed DC scheme will yield a pension of between 40% and 75% of that yielded by the present DB scheme.⁷

A major Canadian study⁸ examined the experience of transferring public sector DB schemes onto a DC basis in Australia, the USA and Canada:

Several US states that have looked at converting DB plans to DC have concluded that it would cost considerably more to maintain similar benefits. Two states that had converted to DC at least partially converted back because of concerns over how little income they were producing for retirees (Nebraska and West Virginia).

After examining the literature on the experience in other jurisdictions and modelling what the ramifications would be in converting a large DB plan to DC, the report concludes that **none** of the stakeholders (employers, employees, taxpayers - who must support those unable to look after themselves in retirement, future generations and society at large) would ultimately be better off.

3. Switching from DB to DC has the perverse effect of *increasing* risks for the scheme

The scheme splits into two funds, a DB fund and a DC fund. Because the DB fund no longer receives any contributions from members, it must pay the DB pension benefits that have already been accrued by selling its investments. This makes the fund vulnerable to fluctuations in asset values (which it is not under the present arrangements, since

⁷ M. Otsuka (2017) 'By USS's own estimates, UUK's DC proposal would reduce our future pensions to 40%-75% of our current DB promise'. Available at: <https://tinyurl.com/motsukauss>

⁸ R.L. Brown & C. McInnes (2014) *Shifting public sector DB plans to DC: The experience so far and implications for Canada*. Canadian Public Pension Leadership Council, p.1. Available at: <https://tinyurl.com/BrownInnes>

contributions exceed benefit payments). This new risk leads the trustees to shift the assets into low risk investments with fixed, low returns (this is known as 'de-risking'). The assets are now insufficient to cover the future pension payments. A real deficit has been created, where none existed before.

To quote again from Brown & McInnes:

In addition to bearing perpetually increased costs for the new DC plan, the post-transition plan sponsor (often government) would face an increase in financial risk coming from the closed DB plan that would run parallel to the new DC plan for many decades. Over the first few decades, while these increased risks would be large, government could choose to bear higher costs for the closed DB plan rather than higher risks. This could be achieved by partially de-risking the closed plan's investment portfolio, but doing so would increase the cost of running the closed plan by about 38% for those first few decades after the transition.⁹

Something of this sort has already happened to the Keele Superannuation Scheme, the pension scheme formerly run by Keele University for staff not in USS. This scheme was closed to new contributions in 2013; as a result its deficit has shot up from £18m in 2013 to £33m in 2016.¹⁰ The University is having to pay £1m per year for 20 years to reduce this deficit, which is largely an artefact of its own decision to close the scheme.

The essential point is that a pension scheme is more viable as a going concern than when being wound down. Closing it, or closing one section of it, is much more costly and risky than keeping it going.

4. Is the USS sustainable as a DB scheme?

We would urge you to read Dennis Leech's useful summary of the issues.¹¹ The USS is not in deficit in the usual sense of the term. Income from contributions by employers and members (£2bn in 2017) outweighs pension payments (£1.8bn in 2017). USS is cash-rich. It made a return of £10bn on its investment portfolio in 2017 and continues to invest its surplus in a range of assets.

The question of whether USS will be in deficit in the future is highly uncertain and rests on economic speculation and theorising. The changes proposed by UUK are premised on a highly **unreliable and disputed** valuation methodology, which values the scheme on the assumption that it is about to close. This calculation is highly sensitive to the assumptions chosen.

On a 'best estimate' basis the scheme has a £8.3bn surplus; on the proposed basis the scheme has a £5.1bn deficit. The deficit fluctuates wildly from month to month, due to variations in the gilt rate, despite the fact that nothing objectively has changed in the scheme's assets or financial obligations.

⁹ n.8, p.2.

¹⁰ Keele University Annual Accounts, 2012/13-2015/16, Available at: <https://www.keele.ac.uk/finance/accounts/>

¹¹ D. Leech (2017) 'Is the USS really in crisis?' Available at: <https://tinyurl.com/leechuss>

Conclusions and Implications

It must be concluded that:

1. Aon Hewitt's calculations are broadly in agreement with those of First Actuarial; it is the models that are misleading. On a like-for-like basis, we are facing a reduction in pension earned under the proposed system approaching 50%, though with higher-paid members treated more favourably.
2. Defined contribution schemes are an inefficient way of providing pension benefits, and this will affect recruitment to the sector and to individual institutions.
3. Defined contribution schemes fail to provide security in retirement or pooling of risk between members, which is the **essential** function of a pension scheme.

Keele is likely to feel the implications of the above more acutely than the Russell Group institutions, and many comparator institutions, when recruiting and retaining staff. This will have a profound effect on student experience, research excellence and - of course - staff morale.